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"Recovery? Never has the end of a recession been so widely anticipated, so widely advertised, so emphatically predicted by both the Administration and the economists. Every blip in the leading indicators, every move in the consumer confidence index, every jiggle in interest rates or production figures, every utterance by Fed Chairman Greenspan is pounced upon by the optimists."

Richard Russell, Dow Theory Letters, April 17, 1991

HIGHLIGHTS

The so-called new "bull" markets in the dollar and U.S. stocks rest crucially on the assumption that the U.S. economy's recovery is just around the corner. That's still open to serious question.

We don't see anything that might trigger an economic recovery. What makes us more convinced than ever that the U.S. is heading into its most serious post-war recession is the collapse in the credit and wide-money aggregates.

The steep downtrend of M4 growth — virtually a collapse — is absolutely unprecedented.

The U.S. is experiencing the sharpest drop-off in credit growth of the entire post-war period. Adjusting for inflation and allowing for the effects of compounding interest, recent credit figures clearly point to a credit contraction unprecedented in magnitude.

To us, this looks more like a credit contraction than a credit crunch. Essentially, such steep declines in new borrowing imply a steep decline in spending and incomes.

The credit figures leave little doubt as to the immediate cause of the steep downturn of domestic demand in the U.S. as well as some other countries: collapsing credit growth.

The reason most American economists are so complacent about this credit collapse is that they have never experienced one. The last time it happened was during the 1930s.

A key contrast to past recessions is that the current downturn is being driven by large falls in construction and consumption. For the U.S., there is only one historical precedent for a recession led by these two demand categories . . . the economic downturn that started in 1929/30.

The most crucial part of the present monetary easing — the banking system expanding its loans and investments — is still grossly absent. Something is going badly wrong in U.S. monetary policy.

The last hope for the recovery is the consumer who is financially stressed as never before in the post-war period. To think that the American consumer can be the locomotive for the U.S. economy's predicted recovery is outrightly absurd.

THE ANGLO-SAXON CREDIT COLLAPSE

It was truly breathtaking how virtually everybody — Mr. Greenspan, economists, traders, treasurers and investors worldwide — instantaneously jumped to the conclusion that the Gulf victory should revive confidence and thereby soon end the U.S. recession. Fear of missing a bull-market cycle in U.S. stocks and the dollar spooked the herd into a blind stampede.

Conventional wisdom on Wall Street says that a bull-run in the stock market is the most reliable precursor of an economic recovery. The collective assertions of the market are held to be more rational than that of any individual. Instead of being duly impressed by this self-praise, we couldn't help but think of the derisory remark made by Keynes about traders and markets: "*Men like dogs are only too easily conditioned and always expect that, when the bell rings, they will have the same experience as last time.*"

Wall Street and the currency markets have gambled heavily on a "conventional", quick and sizable recovery of the U.S. economy. Most people, clearly, have yet to realize that this is a thoroughly unconventional recession with thoroughly unconventional causes.

A BID FOR REALITY

Together with the refusal to see anything more than a short, shallow recession, there is an equally stubborn refusal to analyze the deeper causes of the U.S. downturn. Alan Greenspan, the Fed chairman, finally admitted that a recession was under way just in time to inform the public that the worst was already past. It would be much easier to have faith in his pronouncements had he been at least prescient enough to see the economy's steep slide ahead of time.

Most people, it seems, have yet to realize that the present downswing in U.S. real GNP growth already started in early 1988 (see chart on page 3 of the last letter) and will have been in progress some 13 quarters by the middle of this year. What's more, starting in the second half of last year a gentle slide suddenly turned into a vicious dive. This pattern of an abrupt plunge in economic activity following a prolonged slowdown is unprecedented.

The incorrigible optimists take comfort from the fact that the recession has remained mild by historical standards when measured by the rate of GNP decline — 1.6% in the fourth quarter of 1990 and 2.6% in the first quarter of 1991 taken at annual rates. That compares with a decline of 5.5% in the fourth quarter of 1981 and 5.9% in the first quarter of 1982.

Comforting as this comparison seems, it entirely ignores the most crucial aspect of the current U.S. recession that actually qualifies it as being much more serious than in 1981-82. Then, the decline was mainly due to brief bursts of inventory liquidation.

The most critical point of comparison is this: Final demand only fell 1.6% in the fourth quarter of 1981 and remained practically stagnant thereafter. However, final domestic sales fell by 2.2% during the fourth quarter of 1991 and by 3% during first quarter of this year.

Worst of all is the difference in the income performance between the 1981-82 recession and today. In

1981, disposable real personal income *rose* 2.5% complemented by a personal savings rate of 6.4%. In the past twelve months, by contrast, real incomes have fallen 1.4%, the severest yearly drop on record whereas the personal savings rate has declined to a miserable 3.7%. More recently, real disposable income has virtually plunged, falling 3.5% in the fourth quarter of 1990 and a further 1.6% in the first quarter of this year.

CONSUMER RECESSION VERSUS INVENTORY RECESSION

The above comparisons point to the crucial distinction between this unfolding recession in the U.S. and all the other post-war recessions. The latter were all mainly due to an over-accumulation of inventories and some overbuilding during the boom. The downturns were sharp but brief since inventory movements are quickly reversed and do not imply a longer-running decline in basic demand.

This recession isn't of the same family at all. So far, inventories have generally remained lean. Inflationary overspending during the boom was concentrated on private consumption and construction — commercial overbuilding in particular. It should be no cause for wonder, therefore, that these two grossly overexpanded areas now end up on the leading edge of the recession.

At the root of this recession is a nose-dive in spending on durable goods and residential construction — the latter dropping at an annual pace of 26.5% in the first quarter after an already astonishing 20.6% drop in the previous quarter. Note than both kinds of expenditures are heavily dependent on credit. In short, in its origin, this recession is a consumption and construction recession. That is at utter variance with the pattern of all other post-war recessions.

For the U.S., there is only one historical precedent for a recession that's led by private consumption and a deep construction slump . . . the economic downturn that started in 1929/30.

ANGLO-SAXON EUPHORIA — ANGLO-SAXON REALITY

Rare as the current type of recession may be in the U.S., there are some striking contemporary parallels elsewhere — above all in Britain. There, too, the downturn in GNP growth started in early 1988; there, too, domestic demand fell into a sudden tailspin last year and was led by consumers.

Given these and many other parallels between the economic developments in Britain and the United States, we have found the comparative analysis very revealing. Both countries witnessed a debt-driven consumption boom; consumer borrowing ignited into a binge, spurred by rising home prices which provided the collateral plentifully. And as it happened, the worst portion of these excesses in both Britain and the United States took place between 1987 and 1989.

THE INCREDIBLE SHRINKING CREDIT SYSTEM

Money for spending can only come from two sources: current income or credit. What occurred in both of these countries last year was that a virtual collapse of credit-financed spending primarily hit consumption and construction. The contraction is generally the exact counterpart — the unwinding — of the prior expansion.

In Britain, borrowing has slowed to an annual growth rate of about 10% as compared to a peak rate of 25% in 1987-1988, at the height of the boom. Broad money growth is down from 20% to the 8-9% range. In March, bank lending virtually stopped, rising by just 0.1% on the month.

Even more stunning is the reversal of credit growth in the United States. In the fourth quarter of 1990, consumer and business debt grew a mere $232 billion, or at an annual rate of 2.9%. In January, it was down further to an annualized level of $200 billion. That compares with $603 billion in 1988, $526 billion in 1989 and $460 billion (taken at an annual rate) in the first half of 1990. (See table below)

U.S. LOAN GROWTH: PRIVATE SECTOR
(% Annualized)

PERIOD	TOTAL PRIVATE	CONSUMER	BUSINESS
1988	9.5	10.9	8.2
1989	7.3	8.9	6.7
1990	5.2	6.2	3.4
1990 III	5.1	6.6	3.6
IV	2.9	5.0	1.1

Source: Flow of Funds, Federal Reserve Board

This is the sharpest drop-off in credit growth of the entire post-war period. During the ferocious Volcker squeeze of 1980-82, private credit growth reached a low of only 6.9% in 1982 with consumer price inflation running at 3.8%. Considering today's inflation rate of more than 5% plus the added effect of compounding interest payments on higher debt levels, to us, this looks more like a credit contraction than a credit crunch.

Essentially, such steep declines in new borrowing imply a steep decline in spending and incomes. That's what actually happened in these two countries.

In the United States, total domestic demand declined at an annual rate of 4.4% during the past two quarters. Improving net exports diminished the GNP decline to 2.2%. Considering that net exports constitute less than 1% of GNP, its recorded impact on GNP is certainly sensational.

RECENT ECONOMIC COMPARISONS

	INDUST. PRODUCT'N		RETAIL SALES	
	3 Mths.	1 Year	3 Mths.	1 Year
United States	-8.5	-3.3	-11.0	-4.7
Britain	-5.8	-2.8	+ 3.3	+2.0
Germany	+4.1	+4.0	+ 9.6	+9.4

Source: The Economist, Economic and Financial Indicators

American economists automatically equate an improvement in net exports with rising foreign demand while the markets tend to interpret it as an export boom. Both are utterly wrong. According to published trade figures, U.S. merchandise exports have stagnated since October of 1990 and therefore have added very little or nothing to GNP growth. Instead, the net gains resulted from declining imports (reflecting falling domestic demand) and from rising U.S. business profits abroad.

To get a more realistic picture of the economic situation, we recommend a review of two key demand components: industrial production and retail sales. The above table compares the trends in these two aggregates for the United States, Britain and Germany.

In Britain, domestic demand plummeted in the fourth quarter of last year at an annual rate of 8%. Consumption fell at a rate of 4% and fixed investment sank 16%. Manufacturing investment was down

a horrible 17% compared to the peak level reached in the first quarter of 1990. Industrial production in February had fallen to 5.6% below its level a year ago.

During the first quarter in the United States, total domestic demand declined by 4.5% at an annual rate, consumption 3.4% and fixed investment 5.4%. Industrial production in March was 3.3% below its year-ago level.

FUNDAMENTALS VERSUS CONSUMER SENTIMENT

Consumer sentiment did soar with the end of the war according to various surveys. However, for obvious reasons, hearty sentiment failed to translate into higher spending because purchasing power has not followed through. In order for consumers to drive new upturns requires jobs, rising real incomes, and a credit expansion — seeds that haven't even sprouted yet.

In our view, there is too much talk about psychology, particularly in the United States, and far too little attention on income and credit trends, the latter in particular. The credit figures leave little doubt as to the immediate cause of the steep downturn of domestic demand in the two countries: collapsing credit growth.

All through the 1980s, consumer spending in Britain and the United States had been literally "inflated" by grossly overproportioned borrowing. After such a heady period of credit-dependent growth, slashing the rate of credit expansion in Britain from 25% to 10% and in the United States from 10% to 3% is virtually guaranteed to trigger a savage compression of domestic demand.

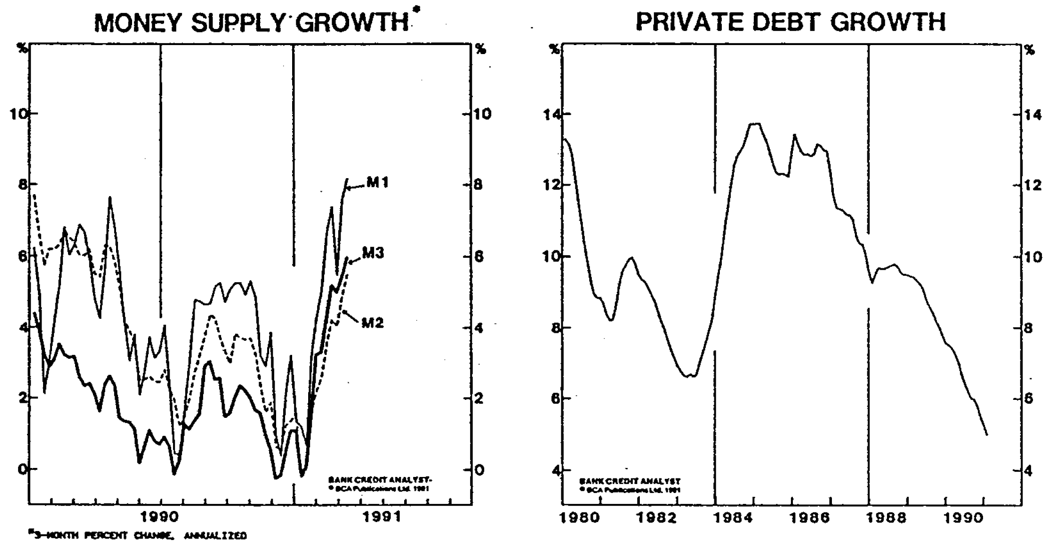
TWO DIFFERENT TALES: CREDIT VERSUS NARROW MONEY

While we find this analysis all so obvious, we wonder why we are so alone in this view. The reason, obviously, is that we are looking at completely different aggregates. While the majority in Britain and the U.S. have traditionally been fixated with the short-term movements of narrow money (M1, M2), our focus is on the trends in credit and broad money growth (M3, M4). In fact, the trends of these two sets of aggregates have become increasingly disparate over recent years in a number of countries.

In hindsight, the emphasis on slowly-growing narrow money combined with a gross neglect of exploding credit was the precise reason why various central banks blundered into over-expansive policies during the past years. That is certainly true for Britain, Australia and Canada. It appears that the same central banks are now determined to make the opposite mistake in neglecting dangerously low credit figures.

Indications are that that mistake has already been made in the U.S.. It is an open secret that the Fed refused to ease in October of last year because the hawks were convinced that a sharp upturn in the money supply at that time foreshadowed an economic recovery. In hindsight, we know that the economy was actually nose-diving at the time. The two charts on the next page show the contrasting trend of short-term growth in the money aggregates (3-month percent change) and private debt growth. The chart on the left incites worry of inflation whereas the one on the left ominously points to depression.

M1 and M2 once again showed a sharp acceleration at the beginning of this year. Mr. Greenspan



Source: Bank Credit Analyst, April

strongly argued the implications of this development. For comment, the following quotation from the March issue of Monetary Trends published by the Federal Reserve Bank of St. Louis: *"M1 increased at an 8.2% annual rate during the first two months of 1991, after increasing 4% during 1990. Normally such an acceleration in M1 growth would be interpreted as an indicator of stimulative monetary actions. A more detailed analysis suggests that one should be careful about such an interpretation. Most of the sharp acceleration in M1 growth this year has resulted from a sharp rise in the currency component of M1. Currency in the hands of the public increased 10.9% in 1990 and at a 23.1% pace in the first two months of 1991. In contrast, total checkable deposits only rose at a 2.6% rate thus far this year."*

As it turns out, more than 80% of the increase in M1 can be attributed to currency-in-circulation and money market funds, neither of which are stimulative.

The popular perception is that the Fed has eased enough to restimulate the economy. This widely-held belief has been buttressed by Wall Street's stock market boom which the consensus attributes to "excess liquidity". In this view, the "liquidity-driven" stock market is the obvious indicator and precursor of an impending "liquidity-driven" economic recovery.

Ever since Wall Street and the media began cooking up this story of "excess liquidity" sequentially driving the markets and the economy, it has been clear to us that this argument was based on great misconception and delusion. To repeat ourselves again: The credit contraction is the infallible warning sign of growing illiquidity.

Taken in this sober light, rising money supply could well be a symptom of the opposite of "excess liquidity": namely, a liquidity scramble. High debt burdens and the struggle to avoid bankruptcy themselves create a need for ready cash, while widening fears of illiquidity gives rise to a flight to liquidity.

IS THE CREDIT CRUNCH STILL AT WORK?

Is there a credit-crunch in the United States or isn't there? Since the consensus view is that the U.S. economy is on the verge of a recovery, it logically implies that the consensus doesn't see any banking and credit problems.

In Goldman Sachs' March issue of International Economic Analyst, a study addresses the question of whether a world economic recovery may be constrained by any such phenomena as a credit-crunch, a capital shortage, a liquidity trap or debt deflation.

The author flatly discards any of these "theories" and ends with the conclusion: "*Bank lending and broad money growth certainly seems to have slowed in several key economies but it is far from clear that this is in any way abnormal for a period in which economic growth is weak. In the U.S., in particular, the behaviour of bank lending seems very well explained by trends in the demand for credit, leaving little room for supply side problems.*"

Of course, the author is perfectly right. Sharply shrinking private credit demand is typical of recessions. So, why worry this time?

The author of the Goldman Sachs study — like the consensus — fails to mention and address the two crucial differences at play this time: one is the magnitude and the other is the underlying cause of the present "credit crunch".

The present credit crunch is unprecedented in magnitude. During the deep recession of 1981-92, private credit grew 9.4% and 6.9%, respectively. This time private credit growth is down to 2-3%.

As for the underlying causes, in past recessions, declining credit growth largely reflected inventory liquidations which were part of the reliquefication process that set the stage for the following recovery. This time, though, the credit contraction mirrors contracting consumption, construction and investment. That's a critical difference that carries important implications for the recession's depth and length.

CREDIT SQUEEZE SPILLS OVER INTO AN INCOME SQUEEZE

As shown, this recession had its starting point in the collapse of credit-financed spending. That's just the first-round effect in the process. As businesses are confronted with rapidly shrinking demand for their products they begin to slash employment thereby curtailing consumer incomes. A vicious circle gains force; the credit squeeze is compounded by an income squeeze which both serve to reinforce each other.

In the United States, consumer incomes are falling even faster than consumer spending. In Britain, in the early going, it was spending that fell faster than incomes. More recently, accelerating job losses are increasingly cutting into income. In March, British unemployment had its biggest monthly jump since record-keeping began 20 years ago.

A NEW DEPRESSIVE INFLUENCE: AN INVESTMENT SLUMP

The central plank in all the recovery stories is that the American consumer will lead the recovery thus soon enabling America to pull other countries out of their recessions. Memories of the early 1980s seem to have been awakened, particularly so in the currency markets. It's really a ridiculous idea. To do so, the American consumer would need either sharply rising real incomes or sharply rising credit. Neither looks feasible, let alone probable.

Far from being lifted by rising consumer spending, the reality is that a third depressive influence is now under way in the U.S. and British economies: an investment slump. Faced with the lethal combination of falling sales and dismal profit trends, businesses are paring back investment plans as well as employment. In the first quarter of 1991, business fixed investment plunged 14% after a fall of 6.1% in the previous quarter, sliding to a level last seen in 1988.

It's perfectly logical that surveys show deteriorating business confidence in contrast to improved consumer confidence. As measured by the regular Conference Board Survey, American businessmen are more pessimistic about economic prospects now than at any time since the depths of the last two recessions.

THE DOLLAR LOGIC

For the dollar, the script of a cyclical U.S. recovery against a background of a cyclical decline in Europe has been written before, the last time being in 1982-83. Apart from the fact that we doubt the case for an imminent U.S. recovery, there are also some important differences in the market conditions for capital flows. In the summer of 1982, U.S. long-term government bonds yielded 13% versus 8% today. During the sharp cyclical recovery that ensued, stock and bond prices soared reflecting steeply falling interest rates. In other words, it was a mix of high interest rates — that being in a relative sense — and a declining rate trend that sucked in the foreign capital in turn driving the dollar up.

Today's capital market conditions couldn't be more different. First, U.S. interest rates are the lowest in the world. Furthermore, short-term interest rates at present hardly cover the trailing inflation rate. Based on interest rate differentials the dollar isn't competitive at all.

Nevertheless, "dollar bulls" counter that U.S. interest rates will rise as an economic recovery gains hold and as foreign rates fall. This argument overlooks the fact that interest rates tend to continue falling well into the early stages of economic recovery. During 1983, rates kept falling until midyear even though the economic recovery had already lifted off like a rocket. Actually, the "dollar bulls'" case for rising U.S. interest rates would make an even more sure case for an anaemic recovery.

BLEEDING FROM MANY WOUNDS

Both the so-called new "bull" markets in the dollar and U.S. stocks rest crucially on the assumption that the U.S. economy's recovery to full health is just around the corner. Will the consensus forecast for a recession-end by June of this year stand? At the moment, that's the key question upon which the stock and currency markets are heavily dependent.

Even in the face of economic data that are mostly worse than expected, optimists pin their hope for a recovery on three central assumptions: first, that the Gulf War victory will have revived the consumer's confidence and his willingness to spend; second, that easy money and low interest rates will buoy the economy; and thirdly, that historical averages argue that this recession should be over in a few months.

Careful analysis of the relevant facts to each one of these suppositions reveals that all three are grossly out of touch with reality.

The Gulf-War victory as a catalyst for consumption is quickly losing credibility. We discarded the notion that the Gulf war was the cause of the economic downturn very early on (see November letter). Consistently, our view has been that the causes of this U.S. recession are complex, deep-seated and cumulative . . . all problems not prone to being cured simply by doses of optimism.

A key contrast to past recessions — we can't overemphasize — is that the current downturn is being driven by large falls in construction and consumption. The latter development is the most unusual and most significant since consumption accounts for approximately two-thirds of U.S GNP.

Why the slump in consumption? Real disposable income is falling sharply and so is consumer borrowing. Consumption is a function of income and credit, and both are trending down together. Both of these facts are obvious and are not imaginary.

What then is causing this contraction in income and credit? It is a particularly virulent mix of fundamentals. Incomes are sliding because businesses are slashing employment. That's happening because of a profit-squeeze, illiquidity, and falling demand. Consumption falls because wages fall. Wages and business investment fall because profits and sales fall. But wages, profits, and sales all fall because consumption and investment fall. Everything becomes both cause and effect.

This last analysis must be seen in the light of a host of interacting and self-reinforcing causes which have all cumulated over the past boom: overconsumption, overbuilding, overindebtedness, a latent banking crisis and last but not least, a widespread profit crisis. All of these narrow the odds that the downward spiral can be easily arrested.

Many people, though, take comfort from the fact that the U.S. economy has been living with all these problems for years, again and again defying forecasts of disastrous consequences. In answer to that observation, consider Schumpeter's quote regarding the outbreak of the Great Depression in 1929-30:

"As a man may suffer from many ills and yet for an indefinite time lead a vigorous life without being seriously inconvenienced by them until, when his general vitality has ebbed away, these ills may suddenly acquire paramount or even fatal importance. So the economic organism always bleeds from many wounds which it bears lightly in three out of four cycle phases, and which spell discomfort when one cycle, distress when two cycles, catastrophe when all the cycles are in the depressive phase."

ECONOMY WITHOUT AN LOCOMOTIVE

For the financial world, a U.S. recovery remains a foregone conclusion. Yet, as to how the recovery will come about, no one seems to be able to provide a satisfactory answer. Just what will be the

locomotive? Fiscal policy is paralysed by the mammoth budget deficits. Exports are stagnating due to the slowing of the world economy and, in any case, would be quickly choked off by a dollar recovery. What about business investment or residential building? For the time being these demand components are slumping also and fundamental conditions speak for much of the same.

The last hope, for good reason, is the consumer. That would conform to the typical pattern of the U.S. business cycle only this time there is a snag. The American consumer, too, is financially stressed as never before in the post-war period. Falling real incomes coincide with the burden of record high non-productive debt, record-low savings and a drop in home equity in many regions.

Falling home values may be an important part of the consumption conundrum currently since home-equity loans based on rising real estate values played a key role in facilitating the consumption boom of the past years.

In short, to think that the American consumer can be the locomotive for the U.S. economy's predicted recovery is outrightly absurd.

In sum, we don't see anything that might trigger an economic recovery. What makes us more convinced than ever that the U.S. is heading into the most serious post-war recession is the collapse in the credit and wide-money aggregates.

THE U.S. CREDIT COLLAPSE

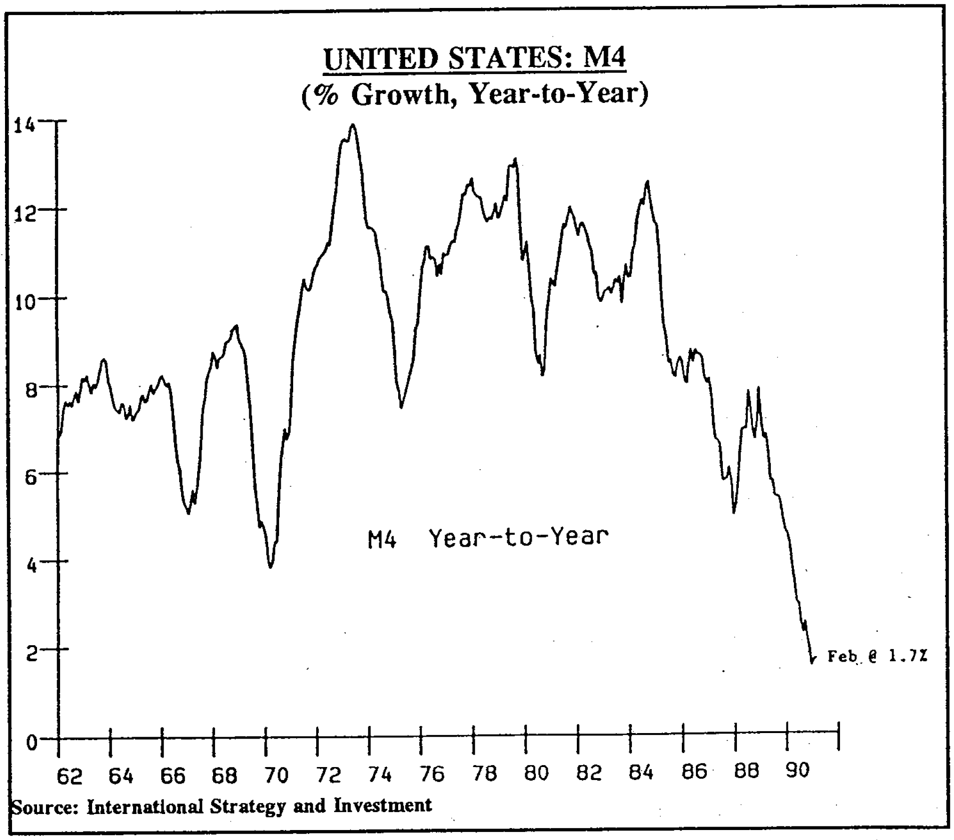
If we were asked what we regard as the single most important factor in assessing the U.S. economy's prospects we would immediately point to credit growth — particulary the lending and investment activity of banks. The banking system is the one and only engine of money growth. When a bank lends, it creates money out of nothing. The effect is the same when it buys securities. In other words, only banks are able to liquefy the economy as a whole.

Total bank lending and investment increased by 4.4% over the last 12 months, 3.4% over the previous 6 months and 4% during the most recently reported 3-month period. Adjusting for inflation and allowing for the effects of compounding interest, these figures point clearly to the case of a credit contraction.

It's instructive to view this recent experience from a longer-term perspective. In particular, it's interesting to see what happened in this respect during the deep recession of 1981-82.

For purposes of comparison, we have chosen the money aggregate M4 or L because it is the widest measure of the development of liquid assets. It reflects short-term borrowing and lending in and outside the banking system as well as treasury bills and commercial paper.

Please take a look at the graph on the next page depicting the growth trend of M4. The steep downtrend of M4 growth — virtually a collapse — is absolutely unprecedented. Take a look at what happened in the late 1970s and early 1980s during the Volcker squeeze. There was no such collapse then.



For the first time since this recession started, Mr. Greenspan has recently admitted that the Fed considers that tight bank lending policies are a major cause. Considering how staggering the figures are, that admission comes rather late.

Here are the latest figures: Between the end of September 1990 and the end of March 1991, total loans and security holdings of banks increased $43 billion or 3.4%. But foreign-related banks which account for less than 10% of the market, contributed $29 billion of this expansion. Domestic banks expanded their total loans and investment by a mere $14 billion or 1% taken at an annual rate. What's more for the domestic banks, government securities accounted for the entire increase while loan growth has been zero since last summer.

At the same time, we shouldn't forget what's been happening at the other large body of depository institutions: the ailing Savings and Loans Associations which are haemorrhaging at an accelerating pace. Last year, they lost about $126 billion in deposits and assets following a $78 billion shrinkage in 1989.

The reason most American economists are so complacent about this credit collapse is that they have never experienced one. The last time it happened was during the 1930s. The consensus thinking simply goes like this: There's absolutely no doubt that a Fed easing will be successful. Why? Because it's never failed before in the postwar period.

In reality however, credit expansion — an absolutely indispensable precondition for an economic recovery — is conditional on the action of the banks. The Fed can lower its interest rates and flood the banks with reserves as it has already done. But whether or not such a monetary easing successfully translates into an effective monetary and economic stimulation completely depends upon an expanding banking system.

It is now almost two years since the Fed started to ease, an easing which over time has become increasingly aggressive. Short-term rates are already very low and bank reserves are as ample as ever before. However, the most crucial part of the monetary easing — the banking system expanding its

loans and investments — is still grossly absent. Something is going badly wrong in U.S. monetary policy.

SUMMARY CONCLUSIONS

The U.S. recession, as we've repeatedly emphasized, has complex causes including structural distortions and widespread financial stresses. But the key factor which most certainly dooms the economy and the stock market, in our view, is the credit collapse. That in turn implies a collapse of income generation. Considering that the past boom was so heavily credit- and debt-driven, the collapse of credit growth spells a deep, deep, recession.

After having gambled so heavily on the U.S. economy's impending recovery, the markets are clearly desperate for confirmation. While the data overwhelmingly show a deepening slump, the markets invariably find a silver lining that signals recovery. Barron's Alan Abelson puts it this way: "*There's always a fly — granted sometimes its only a little one — in the punch bowl.*" All too often, any improvement results from the downward revision of the prior data. Typically, instead of interpreting the Fed's new reduction in its interest rates as an admission that past easings had failed, most economists lauded it as further assurance of an impending recovery. In the same way, every new interest rate cut is immediately seen as the last one.

A recovery won't get off the ground until businesses and consumer reverse their spending slump by initiating heavy new borrowing. After all, that's what a monetary easing is all about. Naturally, it could happen sooner or later but there's no sign of it so far. What's worse, fundamental conditions —a profit squeeze, falling employment and incomes and also the real estate crisis — rigorously speak against any new borrowing binge. In short, it cannot even be claimed that the foundations for a new recovery are being laid.

Looking further ahead, we suspect that the Fed, the Bank of England and the other central banks in recession countries will be forced to lower their interest rates still further with equally doubtful results as before. The big question is when the over-speculated markets — stocks and currencies in particular — will awaken from their dreams of recovery and begin to face reality.

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